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March 9, 1993

Ms. Donna R. Searcy
Office of the Secretary
Federal Communications Commission
Washington, D. C. 20554

Dear Ms. Searcy

Deloitte & Touche is pleased to provide the enclosed comments on CC Docket No. 92-296 in the matter of Simplification of the Depreciation Prescription Process.

Questions concerning these comments and suggestions should be directed to me in Dallas. I can be reached at 214-220-8705.

Very Truly Yours,

John S. Ferguson
Principal

FEDERAL COMMUNICATIONS COMMISSION
Simplification of the Depreciation Prescription Process
CC Docket No. 92-296

COMMENTS OF DELOITTE & TOUCHE

1. These comments reflect our function as accountants and depreciation consultants, so do not address the compliance costs of the alternatives. We endorse the idea of depreciation filing simplification, but have reservations about potential financial reporting implications. Our concern is that the proposal might inadvertently lead to the calculation of depreciation rates from mortality characteristics different from those expected to be applicable to the property in the future.

CRITERIA FOR COMMENTS AND BACKGROUND DISCUSSION

2. The AICPA definition of depreciation accounting includes the following statement that is significant to our comments and suggestions:

Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner.

3. We suggest that the Commission reflect the following basic criteria in its decisions relative to this proposed rulemaking so that changes to simplify filing requirements:

Encourage the determination of depreciation rates that can be demonstrated as being specific to the property;

Continue the endorsement of the use of the equal life group (ELG) procedure and the remaining life technique to calculate depreciation rates; and,

Not complicate property and depreciation accounting as a minimum, and if possible simplify property and depreciation accounting.

Some of the Options seem inconsistent with the Commission's intention to continue to require that property mortality characteristics (life, dispersion pattern, salvage factor and cost of removal factor) be determined in a manner that assures that it can be demonstrated that they are specifically applicable to each depreciable property group.

4. The most important aspect of these basic criteria is the assurance that filing requirement changes do not result in the use of depreciation rates that are not specifically applicable to the property to which the rates apply. Otherwise the integrity of financial statements will be damaged. For this reason, we strongly support the Commission's intention to continue to require that mortality characteristics be determined in a manner that assures that it can be demonstrated that they are specifically applicable to each depreciable property group.
The type of effort to determine such depreciation rates is described on Attachment A, pages 6-21 through 6-29 of Accounting for Public Utilities, provided the emphasis is on the Evaluation Phase. The nature of the Data Collection, Analysis and Calculation Phases is essentially clerical. Emphasizing the Analysis Phase is likely to produce rates that are too low, because history is often a misleading indication of the future. However, simplification of how mortality characteristics are used to calculate depreciation rates may be in order.

5. The systematic and rational principle means that the pattern of depreciation rates should match the pattern of revenues associated with the productive capacity of the assets or to the pattern of consumption or usage of the assets. This matching ensures that financial statements reflect the results of operations and changes in financial position as accurately as possible. When revenues are determined by regulation the consumption or usage of assets is not automatically reflected in revenues. Therefore, regulated entities require conducting book depreciation studies to estimate asset consumption or usage.

6. Depreciation rates apply to surviving property in the future and are calculated from estimates of the mortality characteristics that will apply to the property in the future. Average service lives apply to the investment, so are a measurement of the flow of investment amounts through property records. Likewise, salvage and cost of removal factors measure the flow of salvage and cost of removal amounts through the accumulated provision for depreciation. Therefore, the influence of physical occurrences on depreciation rates is controlled by capitalization policy and accounting procedures such as retirement unit definitions, retirement pricing practices, labor rates, replacement criteria, salvage pricing conventions, material and cost standards, removal and disposal rules, and procedures to distinguish construction labor from removal labor. Since physical occurrences, capitalization policy and accounting procedures are unique to individual carriers, dictated mortality characteristics or depreciation rates cannot be expected to be specifically applicable to the property, so should be avoided.

7. ELG remaining life rates best comply with the systematic and rational principle of depreciation accounting for property utilized at a relatively constant rate over its lifetime, so use of such rates will produce the most accurate reflection of property consumption in financial statements. Remaining life rates provide an automatic true-up mechanism that will be suitable in most situations for reserve differences caused by mortality characteristic changes or unexpected reserve transactions. Situations for which this mechanism is not suitable should be rare and can be addressed as they occur. The sensitivity of ELG rates to dispersion patterns should not preclude their use, as average service lives cannot be determined without also determining dispersion and dispersion also effects remaining life depreciation rates calculated from broad group and vintage group weighting.

8. Other regulatory bodies have promulgated rules that may not have been intended to encourage the use of inadequate depreciation rates, but had that effect nevertheless. The Commission should carefully evaluate its decisions in this Docket to assure that such an unintended effect does not occur.

COMMENTS ON OPTIONS AND SALVAGE AND COST OF REMOVAL ACCOUNTING

Basic Factors Range Option

9. This option can be implemented in a manner consistent with the above criteria, so should be considered.

10. While LEC's and IXC's might warrant separate factor ranges, the small number of IXC's seems insufficient to establish meaningful ranges.

11. Not allowing the use of mortality characteristics outside the range is inconsistent with the basic criteria. Therefore, use of out-of-range characteristics should be allowed with documentation that demonstrates suitability. The required documentation should not be so strenuous as to discourage the use of out-of-range characteristics known to be appropriate.

12. A range should be set for each depreciable property group (primary plant account or subaccount) for each of the four mortality characteristics. There may be reason to urge the use

of the Iowa-type dispersion patterns, as their naming convention is ideal for determining meaningful ranges. As an alternative, do not set dispersion pattern ranges. Use of industry-wide data to set ranges of dispersion patterns is inconsistent with the criteria that it can be demonstrated that the rates are specifically applicable to the property. The impact of industry-wide data on the integrity of financial statements will depend on the data to be used and how it is used:

Average mortality characteristics determined from past industry retirement experience will lead to inadequate rates;

Ranges set from allowed mortality characteristics may lead to inadequate rates; and,

Ranges set from requested mortality characteristics are likely to lead to adequate rates.

13. Periodic filings should be required of the documentation that demonstrates that the mortality characteristics used for depreciation rate calculations are applicable to the property.

14. Filings of depreciation rate changes should include the mortality characteristics used to calculate each changed rate, even if new rates are the result of only changed property group age distribution or book reserve level. Rate recalculations without testing the continued validity of the mortality characteristics should be avoided, as characteristics not tested for validity will produce rates that may not be applicable to the property. Retesting the validity of mortality characteristics every three years is reasonable for property having short lives, so the appropriateness of retesting less frequently should be left to the individual carriers.

15. Use of a formula approach to setting the ranges is reasonable because it is systematic and ranges are easily modified as circumstances change as a result of depreciation rate change filings.

16. Staggered phase-in at the time of normal rate represcriptions is reasonable.

17. Regardless of how revenues are determined, financial statements should reflect depreciation as a cost allocation over useful life. Depreciation rates calculated from mortality characteristics that are applicable to the property are needed with or without price cap treatment. Therefore, carriers subject to price caps can respond to the Basic Factors Range Option in the same manner as carriers not subject to price caps.

18. Independent auditors may not have the expertise to judge the validity of property mortality characteristics, so such judgments should not be limited to being provided by the auditors. Since such certification would have to be based on demonstration of specific applicability of mortality characteristics, this role is compatible with this Option.

Depreciation Rate Range Option

19. This Option would be compatible with the criteria that the filing requirement changes encourage the determination of depreciation rates that are specific to the property if the rates are based on mortality characteristics having specific applicability. Therefore, this Option would need to be structured so much like the Basic Factors Range Option as to suggest that the Rate Range Option not be considered.

Depreciation Schedule Option

20. This Option is not consistent with the criteria that the filing requirement changes encourage the determination of depreciation rates that are specific to the property, so should not be considered.

Price Cap Carrier Option

21. We see no need for this Option, because these carriers would be appropriately treated by the Basic Factors Range Option, provided their rates are determined from the type of study described in Attachment A. However, it would provide the most extensive filing simplification.

Cash Basis for Salvage and Cost of Removal

22. We do not favor departing from an accrual basis for salvage and cost of removal, based on both regulatory and accounting considerations. There would be more benefit from moving toward more adequate recognition of net salvage in depreciation rates than from moving to treatment on a cash basis.

23. The recording and recovery of salvage and cost of removal for property groups exhibiting significant negative net salvage would be shifted to customers not being served by the facilities that generated the salvage and cost of removal. This creates an intergenerational equity problem.

24. The AICPA definition of depreciation accounting addresses salvage, indicating it should be considered in depreciation. Since cost fo removal is not specifically addressed by the AICPA definition, it can be argued that a cash basis for cost of removal is GAAP. However, other pronouncements such as SFAS No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies, accounting texts such as, Accounting for Public Utilities, and Uniform Systems of Accounts indicate that both cost of removal and salvage should be considered in determining depreciation rates. Further, it makes little sense to handle cost of removal differently from salvage. Even though cash basis treatment may be considered GAAP, we suggest that the Commission consider that net salvage is a component of the cost of tangible capital assets that should be distributed over life.

25. Past perceptions of telecommunications property have been that net salvage is not far from zero. However, overhead and underground lines exhibit significant negative net salvage for some carriers. For these and other carriers net salvage may be more negative than realized if the age of current retirements is different from the expected age of surviving property at retirement. This situation will keep measurements of the past from providing reasonable estimates of the future net salvage needed to calculate remaining life depreciation rates. Further, the high costs of handling of hazardous materials may not have been experienced or considered in past perceptions. Therefore, net salvage being material is a logical assumption for deciding this issue.

26. Cash basis treatment of salvage and cost of removal may create earnings volatility. Current trends and changed perceptions may make past experience a misleading indication of the future, and we hope that the carriers will address this issue in their comments.

SPECIFIC COMMENTS REQUESTED

The Basic Factors Range Option

Paragraphs 9 - 18 herein

The Depreciation Rate Range Option

Paragraphs 6 and 19 herein

The Depreciation Schedule Option

Paragraphs 6 and 20 herein

The Price Cap Carrier Option

Paragraphs 17 and 21 herein

The approach to initially establish the basic factor range

Paragraph 15 herein

Separate ranges for LEC's and IXC's

Paragraph 10 herein

The need to establish ranges for all plant accounts

Paragraph 12 herein

The need for mandatory participation

Paragraph 4 herein

Handling of situations for which the current factors are outside the range

Paragraph 11 herein

When to implement the use of ranges

Paragraph 16 herein

Carrier flexibility in selecting basic factors

Paragraphs 3, 4, 6, 11 and 14 herein

Frequency of Carrier basic factor changes

Paragraph 14 herein

Frequency of Commission review of basic factor ranges

Paragraph 13 herein

Procedures for range updating

Paragraphs 14 and 15 herein

Continued use of ELG rates

Paragraphs 3 and 7 herein

Incorporation of true-up mechanism

Paragraphs 3 and 7 herein

Inclusion of net salvage in depreciation

Paragraphs 22 - 26 herein

Is current period treatment of net salvage GAAP?

Paragraphs 24 and 25 herein

§ 6.06 The Book Depreciation Study

As noted in § 6.03, a book depreciation study determines the mortality characteristics applicable to property, uses these mortality characteristics to calculate depreciation rates or depreciation provisions directly, and when applicable, tests the adequacy of the reserve for accumulated depreciation. The emphasis of a book depreciation study is on the determination of the mortality characteristics. Once these characteristics have been determined, the calculations are mechanical.

The mortality phase of a book depreciation study identifies three mortality characteristics:

(1) average service life or life span;

(2) retirement dispersion; and

(3) net salvage.

Figure 6–2 illustrates the processes required to carry out a book depreciation study. The mortality phase of the study comprises collection, analysis, and evaluation of data. Figure 6–2 is a simplified illustration of the work flow of a study. Knowledge gained from work in one area often triggers additional work in another area.

The accuracy with which the accounting records depict physical assets depends on the attributes of the accounting system and the quality of field reporting of physical occurrences. The analyses performed during a book depreciation study measure the flow of dollars through the accounting records. Life analysis measures the flow through the property records and the salvage and cost of removal analysis measures the flow through the accumulated reserve for depreciation.

The flow through both sets of records is controlled by the way *property units* are defined. The definition of *property unit* will determine if an activity is a capital expenditure or an expense. Adding, removing, or replacing a *complete* property unit is a capital expenditure. Adding, removing, or replacing *part* of a property unit is an expense. Recognizing the influence of how a property unit is defined (and other unique accounting system attributes) leads to the realization that attempts to relate the depreciation rates of one utility to those of another are often futile.

Concern sometimes exists regarding the effect of inflation, particularly as it relates to the life analysis. The sophisticated procedures now available for life analysis express retirements at the same price levels as the property to which they relate, and inflation should not be a concern. Inflation concerns are not often expressed related to salvage and cost of removal analysis, but they should be. It is possible to compensate for the effect of inflation on salvage and cost of removal data, but this is usually not done. The effect of inflation is therefore often inadequately reflected in the net salvage factors.

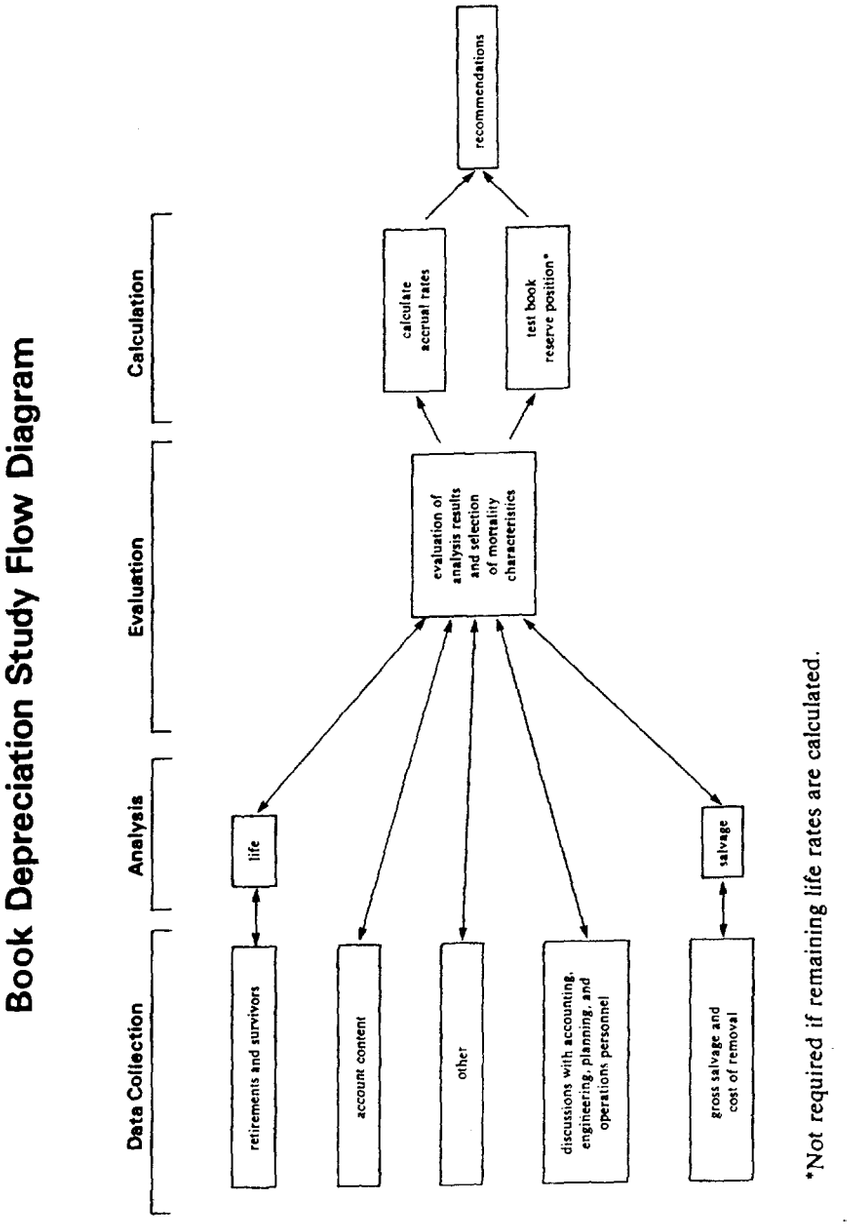

Figure 6–2

(Matthew Bender & Co., Inc.)

[1] Data Collection

Efficient data collection requires an understanding of property records; the construction, retirement, and property accounting system; and the analysis phase of a study. Knowledge of the analysis phase is particularly important, because understanding how the data will be used allows for competent decisions concerning its collection. The types of data collected and the level of effort required are dependent upon the particular record systems and the extent of the evaluation phase of the study. As is illustrated in Figure 6–2, some of the data lead directly to the evaluation phase of the study.

[2] Life Analysis

Life analysis determines the life and retirement dispersion. The techniques employed depend upon the type of property studied and type of data available. It can involve analysis of history, the anticipated future, or both. Life analysis procedures have received considerable attention and have been highly developed.

Life analysis procedures measure the life of the original installations and require the use of computers. Until recently, computer analysis required a high level of technical expertise—to the extent that it overshadowed the fact that life analysis is essentially a clerical task. These days, however, sophisticated analysis procedures can be performed on microcomputers that do not require a high level of technical expertise to operate.

Three groups of statistical procedures for historical life analysis are available: turnover, simulation, and actuarial. The turnover methods attempt to measure the length of life cycles. The turnover methods will not measure the dispersion pattern. A pattern must be assumed to obtain an average service life. A further limitation of some of the turnover methods is the assumption of a constant rate of growth—a situation that rarely occurs over the extended period of time involved in depreciation analysis. Turnover methods are essentially obsolete today.

When dated retirements are known, the actuarial procedure is used. When only the transaction years are known, one of two simulation procedures is used. The *simulated balances procedure* contains a bias that places greater weight on the older history, thereby masking change. The *simulated retirements procedure* gives

the same weight to all periods of history, thereby showing change as it occurs. This weighting difference causes the simulated balances procedure to be most useful for implementing a policy that limits or ignores the evaluation phase, and the simulated retirements procedure to be most useful when the evaluation phase is to be emphasized.

The *computed mortality* procedure is a variation of the simulated balances method. Computed mortality simulates the age distribution of the unaged retirements and applies the actuarial procedure to the resulting simulated aged data. This procedure suffers from the same flaw that caused the turnover procedures to become obsolete—the dispersion patterns must be assumed.

Future life analysis procedures have not received the same attention as historical procedures and continue to require a high level of technical expertise. Analysis of the future involves a prediction of how facilities will be used in the future and when their usefulness will cease. These procedures are often useful for property such as electric generating units.

[3] Salvage and Cost of Removal Analysis

Salvage and cost of removal analysis involves the determination of salvage and cost of removal as a percentage of the cost of the retired property. The techniques employed depend upon the type of property being studied and the type of data available. These techniques can involve analysis of history, the anticipated future, or both. Salvage and cost of removal analysis procedures have received little attention and are not highly developed. The procedures in general use have the ability to measure the salvage and cost of removal of the original installations, but rarely do so because of data limitations. If this situation is not recognized and compensated for, selected net salvage factors will be inconsistent with selected average service lives.

Meaningful analysis requires that the retirements be matched with the salvage and cost of removal they have generated. However, this would require extra data collection efforts, since accounting systems do not usually provide this match—property records maintain data only by property unit within primary plant accounts or subaccounts, and most uniform systems of accounts do not require recording the reserve for accumulated depreciation in any detail greater than the

functional accounting group. The effect on a particular study will depend upon the degree of emphasis placed on the evaluation phase.

The difficulty in obtaining data by depreciable group has prevented sophisticated procedures from being developed for salvage and cost of removal analysis. While this in itself poses no great problem, a problem arises because the salvage and cost of removal analysis phase of a study often receives less attention than the life analysis phase.

In recent years, much of the interest in the salvage and cost of removal aspects of depreciation accounting has concerned identification of components. The literature abounds with discussions of accounting treatment, but there is little related to the determination of the net salvage factors to be reflected in depreciation rates.

The importance of the salvage aspect of depreciation accounting and guidelines for carrying out meaningful salvage studies are examined in detail in an article by John S. Ferguson titled "Salvage Is Also Important."[4] (See also § 6.07 for additional discussion of salvage analysis.)

[4] Evaluation

The evaluation phase is the most difficult element of a depreciation study, because it requires additional data and technical expertise. The extent of the evaluation phase is determined by book depreciation policy. The results of the analyses can either be accepted without question, or they can be used as input to a prediction of the future. Without evaluation, the data produced by the analyses remain only data. With evaluation, the data become information. It is in the evaluation phase that history can be informative and, when used intelligently, can be useful in predicting the future. If the expected effect of future events is to be reflected in the mortality characteristics, it is accomplished during the evaluation.

The issues raised in regulatory proceedings in which a depreciation study has emphasized the evaluation phase will be different than the issues raised when this phase has received little attention. When little attention is paid to evaluation, the issues typically will revolve around the mechanics of the study. When emphasis is placed

[4] *Public Utilities Fortnightly* 19 (Aug 3, 1978).

on evaluation, the issues will concern the bases for the acceptance or departure from history. Because acceptance or departure is based on judgment, it may be difficult to gain regulatory acceptance for the results of the evaluation phase. For this reason, deletion of the evaluation phase may be an appropriate depreciation study policy decision.

In order to evaluate the significance of history adequately, the depreciation analyst must:

(1) know the accounting system that generated the data and remember that the system may not have been designed with the analyst's needs in mind;

(2) know the type of property that created the data;

(3) know the type of property that survives;

(4) know the internal and external factors that affected retired property and will affect surviving property;

(5) know the sources of useful and often nonaccounting data; and, above all,

(6) not lose sight of the fact that the data analyzed are nothing more than a way of reporting that something has happened to physical facilities and that data can be created by the accounting system without anything actually happening to the facilities.

[5] Calculations

The calculation phase covers both the calculation of rates or provisions, and the calculation of theoretical reserves. This phase is essentially a clerical task. The purpose of a theoretical reserve is to test the adequacy of the accumulated provision for depreciation. Rate calculation procedures and techniques are discussed in § 6.08.

Two basic procedures for calculating a theoretical reserve are discussed in the literature, the *prospective* approach and the *retrospective* approach. The retrospective approach seldom provides meaningful information because the required accounting records are not sufficiently complete. Under the prospective approach, the theoretical reserve is future oriented. (The prospective calculation procedure is discussed in § 6.09, below.) The result cannot be expected to be the same as it would appear under the retrospective

approach or with the current accumulated provision for depreciation if any of the following conditions apply:

(1) The future is expected to be different than the past;

(2) The future is expected to be different than it was expected to be under earlier estimates; or

(3) Appropriate depreciation rates have not been used.

§ 6.07 Importance of Salvage and Cost of Removal Analysis

As discussed in § 6.03, the salvage and cost of removal definitions in the FERC uniform systems of accounts are important. These definitions contain terms such as "amount received" and "cost of"—not "current price level" or "present value." Depreciation accounting concepts and regulatory rules (as presently written) require that the amount of net salvage built into depreciation rates be an estimate of the net amount of salvage expected to be received and the cost of removal to be incurred at the time of abandonment or removal. Measurement is, therefore, at the price level expected to exist at the time of receipt and incurrence. The need for adequate analysis of salvage and cost of removal experience has been demonstrated by the changing experience of the past decade, and this need will continue.

Salvage and cost of removal are built into depreciation rates by a net salvage factor usually determined through an evaluation of historical experience. Since actual experience is expressed by dividing actual salvage value and actual cost of removal by the original cost of the retired property that generated the experience, the effect of inflation is inherent in the determination. On occasion, regulators are reluctant to recognize the effect of inflation when history is not available and future inflation must be specifically estimated in order to determine net salvage. This is the current situation for steam generating units, but acceptance of estimates of future inflation are common for nuclear units.

An example of this regulatory reluctance is found in FERC Dockets RP75–105 and RP76–94 associated with Columbia Gulf Transmission Company. The company requested approval of a separate depreciation rate to cover the negative net salvage for its offshore system, estimating the costs at the price level at the time of occurrence. Both the FERC staff and the Public Service Commission of New York (an intervenor) claimed that inflation should not

be included, even though the accounting rules of both commissions required its inclusion. The New York Commission went so far as to suggest a generic proceeding to determine how negative salvage should be handled. In its own deliberations, however, the New York Commission concluded that future inflation should be recognized in depreciation provisions, having done so for the decommissioning of the Ginna nuclear plant of Rochester Gas & Electric Company and the Nine Mile Point nuclear plant of Niagara Mohawk Power Corporation.

When expressed as a ratio of the original cost of property retired (as is required in a depreciation study), experienced salvage and cost of removal are quite sensitive to the age of the property retired. While changes in rates of inflation have been a factor, in recent years it has been age sensitivity that has produced large decreases in net salvage for many electric and gas utilities because of decreased system growth. In addition, the base of knowledge that has developed as a result of studies on the accounting, financial, and regulatory implications of decommissioning nuclear plants has generated considerable interest in age sensitivity and in identifying the magnitude of removal costs for gas, oil, and coal generating plants.

Depreciation rates that are too low as a result of inadequate recognition of net salvage will permanently inflate the rate base, with all the attendant ramifications for various generations of ratepayers. For example, it typically takes approximately seven to nine years for the rate base change from a depreciation rate decrease (i.e., a rate base increase) to offset the initial annual revenue requirement decrease. Thereafter, ratepayers face higher prices than would have resulted had depreciation rates not been initially decreased.